RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**
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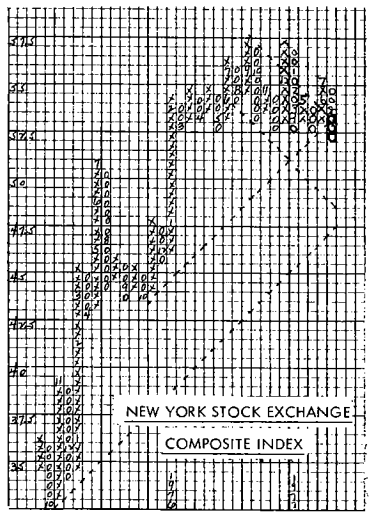
August 31, 1977 **LETTER 707**

Aug 19: DJIA 863.48; PTI 839; A-D ratio -19.48
Aug 26: DJIA 855.42; PTI 828; A-D ratio -20.08

FATEFUL 52.50: In Letter 705 I drew particular attention to a point & figure chart of the NYSE Composite Index (a weighted index of 1532 common stocks on the NYSE). I noted at the time that we had "a perfectly enormous top... with quadruple bottoms at the 53.00 level." I further warned, "...if 52.50 is touched by the Index, I think we should see a general washout for the market, one that I don't want any of my subscribers to ride through."



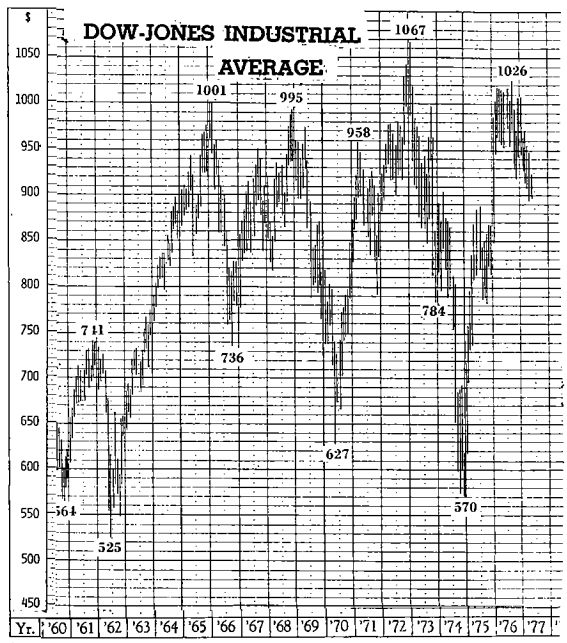
At 11 a.m. on August 26 (last Friday) the NYSE touched 52.29, thus smashing below all previous lows at the 53.00 level. The top on the NYSE was thus completed (see chart). There is, of course, always room for a rally, but I would think that the NYSE Index would now meet major resistance in the 53.00 area. With the violation of the 52.50 level and the completion of the top on the NYSE Index, I feel the chances are heightened for a final dramatic "selling climax" and a classic over-sold market bottom.

Remember, there is a record $9.5 billion in **margin** locked in this market, and we are undoubtedly seeing margin calls going out now. When the margin calls go out, a stockholder either comes up with more money or says "sell." That kind of grim action can produce a market that "feeds on itself" on the downside.

INFLATION? Over the long term inflation may be our big worry, but over the *foreseeable* future the markets think otherwise. What do we have today? We have a deflating stock market, a weak commodity market, falling interest rates (within the powerful long-term sector of the bond market), a stagnant gold and silver price structure, and a glut in oil, many metals and many grains. Call that dis-inflation if you like, call it creeping deflation if you wish, but it's not what the crystal-ball gazers predicted a year ago, that's for certain.

CHANGE: Business loves stability; the stock and bond markets love stability. Personally, I like stability. I remember the old days when you could put your money in IBM, GM and MMM and look confidently towards the future of unlimited growth. Today, you can do no such thing. Study this monthly chart of the Dow (chart courtesy of *Horsey*). Taking the period of 1962 to the present, we have a picture of alternate exuberance and depression. If this chart were a profile of a patient's emotions, any psychiatrist would call it "a case of continuing hysteria."

That's where we are today, and there's no use kidding ourselves. My job is to call them as I see them, and all of us today have the job of trying to preserve our capital (purchasing power) in a mad, mad world. Therefore, if you insist on a "single decision" investment, if you demand "the answer" for your investments over the next decade, forget it. There's only one answer for the investor today, and it's to keep an **open mind.** And there's only one thing that I would tell you to count on—and that's change, change and maybe a bit of violent change!



PRICE MOVEMENT: To know where you are and where you may be going, it is always a good idea to be clear about where you've been. To put it another way, if you don't understand the past, there's a damn good chance that you'll be just as foggy about the future.

Instead of the usual daily chart of the Averages, I've used a weekly chart (page 2) for this mailing. Obviously, the weekly shows more history. So let's go back a bit and review some of the events that led up to today.

The first sign of actual trouble for Wall Street occurred last September 21, when the D-J Industrial Average hit a bull market peak at 1014.79. The D-J Transportation Average (see chart) had already recorded a peak (two months earlier on July 14). Next, a reaction took the two Averages down to lows, Transports to a low of 203.85 (October 12) and Industrials to a low of 924.04 (a month later on November 10).

From the October-November lows, an advance began. The new advance carried Industrials to 1004.65 on December 31. That was a full **10 points below** the preceding September high. But the Transports (by far the stronger Average at the time) posted a new bull market high of 237.52 on January 3.

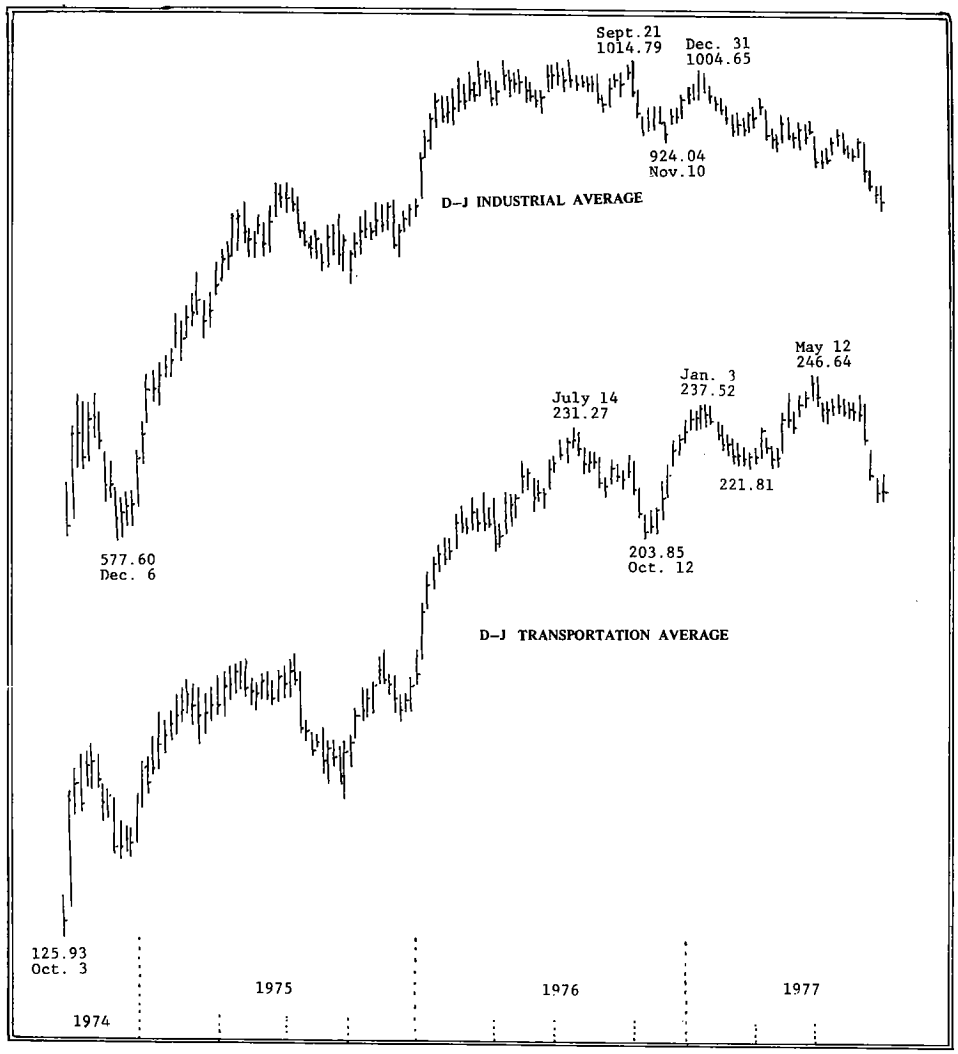
From there the two Averages turned down again. With Industrials having failed to confirm a new Transport high, and with the two

Averages retreating, the preceding October-November lows (924.04 and 203.85) assumed a heightened importance.

Why were those lows so important? According to Dow's Theory, if, following an unconfirmed high by one Average, the two Averages then turn down and jointly break their last secondary lows, it is a most bearish event. If such action occurs during the third or speculative phase of a primary bull market, we have a bear signal and it can be assumed that the primary trend of the market has turned from bull to bear.

It has been my contention all along that we are in the **second** phase of a bull market–not the **third**. Therefore, I felt at the time (and I still do) that if the Averages violate their October-November lows it would be quite bearish for Wall Street, but that such action would ***not*** signal a primary bear market.

As it happened, a most extraordinary period of market action followed the October-November, 1976 lows. The two D-J Averages rallied to year-end 1976 highs, and then totally parted company. In technical parlance, this is known as *divergence* (a period in which one Average rallies while the other declines).



From the first day of 1977 the Industrial Average headed down. By April the Industrials had broken below their November 10 low of 924.04. The Transports **refused to confirm** the Industrial weakness. Not only did they refuse to confirm, they headed higher. On May 18 the amazing divergence reached its zenith as Transports recorded a new bull market high of 246.64.

Industrials continued to trace out their long series of descending tops and bottoms. In late-May the Industrial Average fell below the 900 barrier. I was taking an increasingly bleak view of the divergence, warning that throughout history extended periods of divergence were indicative of *distribution* (i.e., informed selling of stocks).

The next portion of the drama arrived during June and July. A long and remarkably narrow "line" appeared in the Averages. The line formation carried to July 20. At that point both Averages broke decisively down. By mid-August it was obvious that stocks had been carefully and methodically distributed. After July 20 it was also obvious that the Transports were turning weak–weaker, in fact, than even the Industrials.

As I study this extended period of non-confirmations, divergences and out-of-gear movements, I can only think: "So far, the Averages have been telling us a bearish story." But the story is far from complete. And there are many questions, both technical and fundamental, that are still unanswered.

The fact is that the Industrial Average has been falling for 11 months. That's a **long time** for an Average to decline during the corrective phase of a bull market. Even more extraordinary, there has not been so much as a 40 point rally in the Dow since the year 1977 began. It's a rare instance when eight months go by without so much as a 40-point Dow rally. That kind of action doesn't occur once in twenty years (the last time a full year went by without a 40 point Dow rally was back in the recession year 1953).

For the past three months (ever since May 18) the Transports have been following the Industrials down. We don't hear talk of divergence today. And we are hearing less and less about the famous "two-tier market." Furthermore, since July 22 (when the A-D Ratio topped out) the entire NYSE (along with the AMEX and the Over-the-counter markets) has "gotten it together" and the direction has been down.

All right, what happens from here? What do we watch for? From every quarter we hear that "a rally is overdue." My feeling is maybe or even probably, but I am not impressed with the present overall situation. I have been saying that following this long, tedious period of negative market action, the market should become **strongly over-sold** prior to a true bottom. Unfortunately, my data has **not** yet said "over-sold."

I have been asked what data I use for determining an over-sold market situation. I use a number of indicators but foremost are

(1) the odd lot transactions and odd lot short sales, (2) an 8-day moving average of the most-active stocks, (3) a 13 day moving average of the "ticks" (NTIK on the Bunko Ramo machines), a 10 day moving average of the market trend indicator (MKDS on the Bunko Ramo), and last (but not least) my own reading of the Averages.

Question: Russell, tell me a bit more about these phases of the bull market that you keep talking about.

Answer: We saw the first phase of this bull market start in late-1974 and carry to July, 1975. The first phase of a bull market is the one that sees stocks bounce up from the tremendously depressed levels of the preceding bear market bottom–bounce back to what I term "known values."

Following a July-September, 1975 correction, the second phase of the bull market began. That's the phase in which stocks advance as they reflect a steady improvement in the outlook for corporate profits. I would say that the second phase ended around the middle of 1977.

Remember, the phases do **not** have to do with price movement, they have to do with market *sentiment*. As a rule, skepticism on the part of the public runs high during the first and second phase of a bull market. For that reason neither of these phases is accompanied by any large degree of public participation in the market.

Although it does not always happen, the phases of a bull market may be separated by corrections in the price structure. This is particularly true of the second phase. I have noted that the second phase of most major bull markets usually ends with a violent correction and an accompanying period of ***great fear***. Almost without exception, these second phase crack-ups are taken to be "new bear markets."

As an example, the end of the second phase of the great 1949-66 bull market was one of the most frightening periods I've seen on Wall Street. The Dow dropped 20% between July and October, 1957, without so much as a single important intervening rally. By October the gloom was so thick it was as if the end of the world had arrived. By November it was obvious that a business recession had arrived. And I can't help wondering if we are not seeing some of that same kind of action now.

Question: Talk a bit more about the kind of psychology we can expect to prevail as this second phase of the bull market draws to a close.

Answer: In a word, I would say "fearful." Last week's *Time* magazine contained a major article on Wall Street and the stock market which was so dismal I could hardly believe it. The August 25 *Wall Street Journal* column ("Heard on the Street") contained a very bearish piece in which a leading fund manager predicted "an unprecedented and large decline in corporate profits, vis-a-vis general expectations." I believe the "bad news parade" typical of the end of the second phase is starting. By October or November, I expect the gloom to be as thick as an LA smog.

Question: Where do you think this reaction will end?

Answer: The smartest guy on Wall Street doesn't know the answer to that one. Secondary corrections tend to wipe out 1/3 to 2/3 of the previously ***uncorrected*** primary advance. So far, this correction has erased approximately 68% of the entire 1975-76 advance for Industrials. But the correction has retraced only 33% of the 1975-77 Transport advance. The Industrial decline is now in its 12th month, the Transport decline is now in its third month.

On the face of it, the decline so far (in both duration and extent) could suffice as a full correction of the entire second phase rise. But the market is a law unto itself, and it is no respector of "reasonable figures" and "average statistics." I have felt all along that (1) the correction should progress until the market becomes heavily over-sold, and (2) the decline should continue until investors become frightened and bearish and until the cry of "bear market" is heard across the land (even though I don't believe we are in a primary bear market).

As things look now, it would not surprise me to see the Dow move down into the 825 area, and as a shocker I feel that the Dow could drop below 800. But it is folly to attempt to predict where the Dow will stop, once an important secondary is underway. It makes much more sense to try to ***identify*** the area in which the market is oversold.

Question: What about the Transports? What are they telling us with only a 33% correction?

Answer: The extreme reaction bottom for the Transports is 203.85, recorded last October. As long as Transports hold above 203.85, the market will be in the grip of a most important non-confirmation. If this market can become strongly over-sold, in other words if the market can go down to a point where all the indicators register an extreme of bearishness, and in so doing if the Transports continue to hold above 203.85, then I would say that the conditions are ripe for the inception of a major primary advance.

Question: OK, Russell, but suppose Transports violate 203.85? Then what do we have?

Answer: In 1957, preceding secondary lows were smashed as the second phase correction got going, and everybody suddenly "discovered" the Dow Theory and started screaming "It's a bear market!" As far as I'm concerned, I don't believe we're in a primary bear market. The important thing is for this market to go down in a way that will stir up a great amount of pessimism. All the potential sellers have to be knocked out of this market. The market has to go down far enough so that large investment interests once again decide that stocks are "great buys." If it takes a breaking of 203.85 on Transports to bring out that kind of over-sold condition, then that's what is going to happen.

Question: You've been talking about a bottom for this slide in *October*. But what if the market appears over-sold in September–or not until November or December? What would you say then?

Answer: I may be stupid, I may be incompetent, but I'm not stubborn. When this market looks like it's hit bottom, I'm going to say so, and it doesn't matter if that bottom comes in September or January, 1978. It is true that my Fibonacci series work suggests an October bottom, but that's just an exercise in "numbers magic" or maybe even an ego trip on my part. Every analyst has secret fantasies of "playing genius," and, of course, I'm no exception. But I know the danger of trying to be too cute in this business, and I'm always careful to separate my guesses from my cold appraisal of the facts.

I use one adage to keep myself humble in this business. It goes like this: "Watch the intelligent analyst who has been right for a long period of time. He's very close to going wrong. Watch the intelligent analyst who's been wrong for a long time. He's close to being right."

Question: A lot of analysts are saying that the glamor stocks and some of the former growth stocks have stopped going down–and that they are probably buys now. Do you believe that?

Answer: It's true that stocks like MMM, IBM and Kodak have stopped going down. But my experience suggests that we wait for the true bottom of this reaction before jumping the gun. Second phase reactions often end with a massive "selling climax," a downward wipe-out on heavy volume. These selling climaxes can be very scary, and they shake loose everything that isn't nailed down. Following a massive, high-volume selling climax the market usually produces a rally and a second decline (known as a "double bottom") or a period of dullness. That is where I prefer buying–at the double bottom or in the period of dullness following a collapse.

Over the past ten years, the stock market has also had a habit of producing *non-confirmations* in the Averages at important bottoms. If the double bottom or period of dullness is also accompanied by a non-confirmation, I have even more confidence that such an area represents an important "buy spot."

Question: Russell, what do you think is behind this correction?

Answer: I think the market is discounting a business downturn or a recession (with a drop in corporate profits) to hit full during the first half of 1978. I think the market is also retreating to protect itself against the probable removal of the capital gains tax. Furthermore, I think the retreat could be starting to feed on itself, due to margin calls. I have mentioned many times that we now have a record $9.5 billion in NYSE margin. That huge margin is like "a sitting duck," and it may put great pressure on the market.

Question: Russell, you mentioned earlier in the Letter that although the Averages have been telling a bearish story, there are "many questions, technical and fundamental, that are still unanswered." What were you referring to?

Answer: Well, one most fascinating question is the strength of the *A-D Ratio compared to the Dow*. For instance, as of late last week the Dow had wiped out all its gains of 1976 and 1977. But the A-D ratio was still a full 10 points above its 1976 low. It's clear to me that there is just no way that the A-D is going to confirm the Dow on the downside, even if the Dow were to crash from here.

Historically, this is ***not*** the kind of relationship one sees at a primary bull market top (or at a bear market rally top). It is actually the kind of phenomenon that has been seen when major and long lasting bottoms have formed. Therefore, despite the costly and dismal action of the market so far in 1977, the relationship of the Dow and the A-D ratio is long-term constructive. But it could take months, perhaps many months, before this important factor becomes apparent in stock action.

A second mystery is that the bank credit statistics (at least those published by the authoritative *Bank Credit Analyst*) are still bullish, and they have remained so ever since this bull market started. With the advent of a true primary bear market or even an important correction (i.e., a correction based on a forthcoming business recession) the bank credit statistics almost always produce advance warnings.

Furthermore, this whole 1977 decline has been progressing with no hike in the discount rate, the NYSE margin requirements or the bank reserve requirements. Thus, none of the Fed statistics have given their warning (as they usually do prior to major declines or bear markets).

The last time we had a major market smash without any credit, Fed or bank-statistics warnings, was 1962. That correction was based on ***psychology***. The 1962 market turned down through fear of President Kennedy, his negative attitude towards business and more particularly his confrontation with the steel companies.

There is no question in my mind but that the current reaction is, at least in part, Wall Street's reaction to President Carter and his populist plans for the nation and the economy. The fact is that Wall Street doesn't know where Carter stands yesterday, today or tomorrow. The business and investment community is very much afraid that it has a rather erratic, confused, even wishy-washy President at the helm. He's a President who says one thing and then doesn't do it, a President who puts votes ahead of logic, a President who all too often leaps before he thinks.

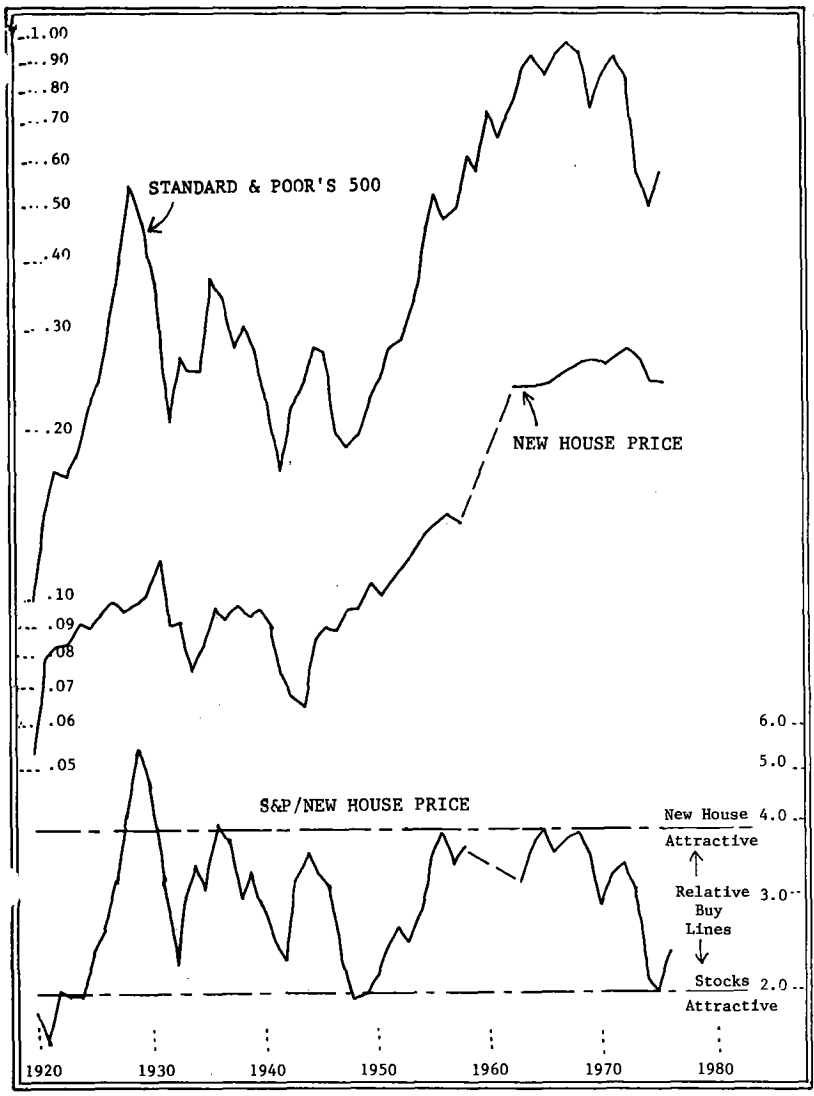
The current spotlight is on the Panama Treaty and Burt Lance. I doubt that the treaty will be ratified in the Senate. And the Lance situation is becoming more grotesque, more idiotic, more untenable (for Carter) with each passing day. I can only wonder what Carter is thinking as he sticks out his neck further and further in the no-win Lance affair. The conclusion (mine and the public's) is clear and ominous enough: if Lance were not a close friend of Carter's, he would have been out–yesterday.

NOTE: Alas, the IBM computer-composer seems invincible — not so the operator (she's in bed with the flu). So, for the rest of this report, excuse us, indulge us, it's back to the old type. But as they say, it ain't the words or the type, it's whether they make any sense.

HOUSES—STOCKS—TAXES: The Carter Administration wants to do away with the capital gains tax. As a trade-off, they want to bring the top tax limit on all income (earned and unearned) down to 50%. The implications of this policy are momentous. The policy is anti-inflationary (which is good), it would, to some extent, move money from non-productive speculations to productive income-oriented vehicles (which is good), but it would discourage risk capital (which is bad) and it would be hell-on-wheels for the real estate operator.

The fact is that houses have been the prime speculative vehicle for the 1970's. People have been buying high-priced homes with the attitude, "I don't give a hoot. I know it's going to cost me an arm-and-a-leg, but it's an investment. It can only go up in price."

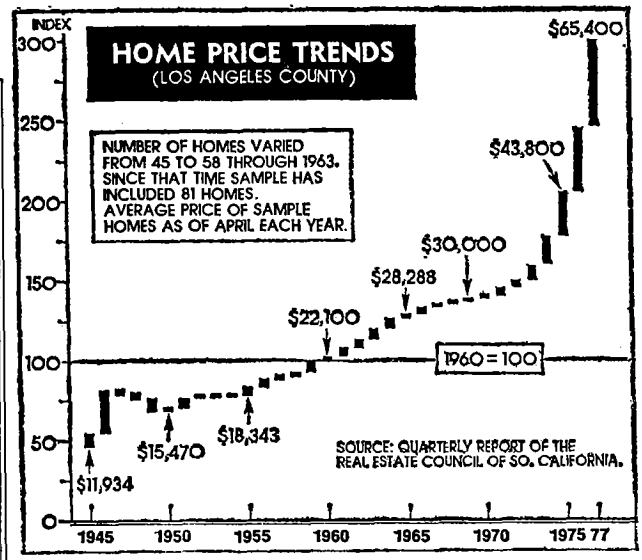
Up in price? Not with an end to the capital gains tax, it won't. Without the tax break, buyers of real estate are going to dry up. That means a top on the value of real estate. Now this is important. People were willing to go over their heads on high-priced real estate as long as they knew their "investment" was popping up 10% to 25% a year. But let real estate level off (it doesn't even have to drop value), and the glamor is gone. That could precipitate real problems for real estate. And with the billions of dollars and millions of people involved, this is an area that will bear the closest kind of watching.



In line with this, I am reprinting a chart of already-existing, single dwelling homes in Los Angeles. The chart pictures what I would term a "speculative blow-off." It's a blow-off which reflects public frenzy. And I think this whole picture is one of the weakest links in the current US economy. Let me put it another way — if this chart was a stock, I would sell it.

All right, now let's go into a little of the background of the real estate boom. One fact is that real estate has been the public's best investment for decades or ever since World War II. The only investment that has never gone down is real estate and more specifically the single-family dwelling. I have often said that I have never seen the price action in anything (houses, stocks, stamps, tulip bulbs, antique cars) go steadily up without ultimately attracting the public and without ultimately bringing in a speculative explosion. Unfortunately, all speculative booms have had their corrections.

Last week I received the Burns-Kirkpatrick Letter (49 Riverside Ave., Westport CT 06880). In that report was a most interesting comment about real estate together with a most informative chart. I have reproduced the chart with permission of Burns-Kirkpatrick. Here we see the price of the S&P 500 Stock Average and the price of a new home in the US (both adjusted for inflation). At the bottom of the chart we see the ratio of the two prices.



What the chart tells us is that there was an extended period during the mid-1950's to the late-1960's in which houses represented good value in comparison to stocks. But since 1968 the big swing has been broadly away from stocks and back to houses. At this point, on a relative basis, houses are expensive and stocks are cheap.

What is this telling us? In my opinion, it is saying: (1) In any downward adjustment from here, particularly if it is deflationary, house values could drop vastly further than stock values.

(2) Houses, relative to stocks, are currently in a high "popularity zone" that has not been seen in thirty years (since the late-1940's). The popular investment is seldom the good investment. Therefore, if you are thinking (at this late stage of the game) of speculating in real estate, forget it. The best speculation in real estate at this time is probably to sell what you have (here again, I will repeat that I do not advocate speculating on your home — your home is your emotional palace, and if you like your home, keep it!).

(3) The popularity of owning a home is such today that many houses are financed on the thinnest and most precarious of margins. This week I heard a radio advertisement for "second trust deeds" (second mortgages) for 13.8% interest. "Why pay 18% when you can get it from us for only 13.8%" the salesman boasted. Now that, in my opinion, is dangerous financing. It's unsustainable financing.

Today millions of citizens are treating their houses as premium investments, investments that "can't go down" in value. These people do not hesitate to take on whopping mortgage costs because they are convinced that the value of their houses can only go up. In my opinion, this line of thinking is as dangerous as it is incorrect.

Remember, this study is not saying that the price of stocks is going up while home values go down. It is saying that on an historical basis, stocks are now terribly unpopular when compared to houses, and houses are terribly popular in comparison to stocks.

Conclusion: On an historical basis, houses are currently extremely popular and very expensive compared with stocks. Many homes are financed on very thin margins. People have mortgaged their homes to the hilt thinking that the value of their homes will never level off or decline.

The price action of the average house portrays a dangerous speculative blow-off. A correction is overdue. The removal of the capital gains tax advantage could dry up real estate interest. The result could be a major price correction in real estate. I believe real estate is the single most over-blown, most speculative area in the American economy today. Real estate has been distributed to the public in the form of over-priced houses, over-priced condominiums, over-priced commercial property (often syndicated), and in the form of mortgages, trust deeds and the new mortgage packages being issued by the banks. This situation bothers me more than anything else in the economy today — except the total debt picture.

NOTES: The last Letter contained an incorrect number for the American General family of no-load funds. The number for this Houston outfit is (713) 526-8561.

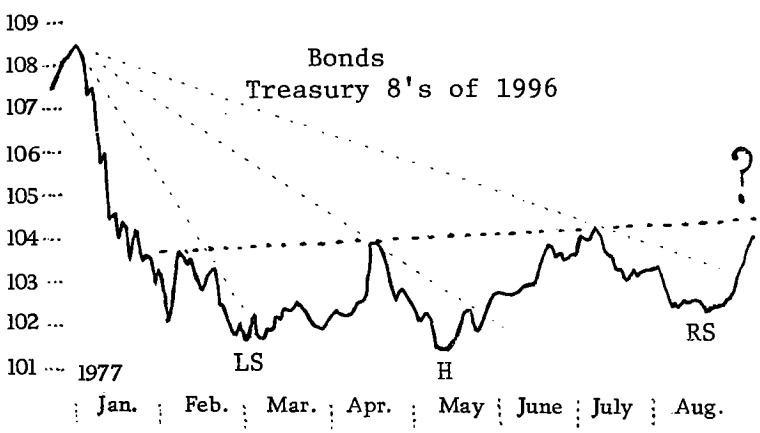
* * *

The latest figures on the moving averages of the Dow are: 13-week MA is 898; 50-week MA is 939. The differential between the two is thus 41 points on the bearish side of the ledger. This is the widest bearish spread since the two MA's provided their bear signal last November. The short-term or 4-week MA is now at 871, 27 points below the 13-week MA. Therefore, it would take some time before the MA's of the Dow could even signal a "bullish alert" (a bullish alert is produced when the 4-week MA pushes above the 13-week MA).

* * *

The bellwether US Treasury (bonds) 8's of 1996 moved just above 104 last week. This was the move that I asked subscribers to watch for (see last report). The bond has now formed a massive "head-and-shoulders" bottom pattern, as seen on the accompanying chart. An upside breakout would occur if the 8's of '96 hit 105. Mine not to reason why, mine but to discover — and report to my subscribers. If the 8's hit 105, we could have an upside explosion in the bond market (for the chart would imply that at 105 the whole floating supply of these bonds (and many others) have been taken off the market).

Let's remember (if the bonds blow off) that there's a time to sell everything, and bonds are no exception. Be emotionally attached to your wife, your kids, your lover, your dog, but not your investments!



LATE MARKET: Industrials got down to 863.48 (Aug. 19), Transports slid to 214.70 (Aug. 19). The slide saw the advance-decline ratio down on 12 out of 14 days or 85.7% in a 14 day period! Odd-lotters stepped up their selling on the decline (which is a plus). On my calculations, the market registered SEMI over-sold, but not fully over-sold. The time period (week before Labor Day) is very favorable for a market rally, and it would seem that a rise into September is overdue. If the market can't mount a rally here, it would appear even weaker than the super-bears have claimed.

The 963.49 and 214.70 lows came in the month of August, a month not traditionally given to long-term bottoms. The single exception was 1896, which saw a bear market end in August. The year 1973 saw an 8-month decline end in August; the Averages then rallied violently into October, whereupon the Industrials smashed to November lows (Transports did not break their August lows until the following year). But all in all, semi-oversold market lows in August do not inspire me. I might remind readers that the Dow has yet (in 1977) to produce so much as a 5% rally! Something like that would appear to be overdue.

No One Knows Why the Market Is Falling

Favorable Forecast
Despite Market Drop, Carter Analysts Expect No 1977-78 Recession

They See Economic Growth Slowing From First Half; An Eye on Capital Outlay

'Wall Street's Just Irrational'

By Richard J. Levine
Staff Reporter of The Wall Street Journal

WASHINGTON—The Carter administration remains convinced that the economic outlook through 1978 is basically bullish, despite a rash of recession fears that have depressed Wall Street recently. ...

Theories Abound as Dow 30 Drops 35 Points in Month

BY RONALD L. SOBLE
Times Staff Writer

Analysts, brokers, floor traders and ...riads more connected with the se...ities industry are perplexed over ... woeful performance of the stock ...rket. In the past month alone, the ... Jones average of 30 industrials plunged some 35 points.

"Nobody's put their finger on it, in...ing me," says John Doherty, chief ...esearch for San Francisco-based ...o & Co.

...e result is a plethora of theories ...hy the market is taking a dive ...what it's trying to tell us.

...rbert Wheeler, an economist ... New York-based Standard & ...s Corp., believes the market is ...ting a slowdown in the rate of

IRRATIONAL: I couldn't resist reprinting these headlines from the LA Times and the Wall Street Journal (both Monday, Aug. 29). The public is disturbed by the slump in stocks, Wall Street is confused, and the Administration is arrogant. The reason for a major market advance or decline is seldom understood at the time, but I've never seen a major movement that was without meaning. When that train heads for home, even the village idiot knows enough to get off the tracks. And that's all we've done, we got off the tracks.

GOLD, SILVER, STOCKS: So far, I prefer money instruments to all of them. But we're drawing closer and closer to an important bottom in stocks. As for the precious metals, 5% to 10% in Kruger-rands is as far as this writer wants to go.

NEXT MAILING: September 9th